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Venture Capital Primer For Small Business

Financial
Management
Series

Building America's Future

Summary

Small businesses never seem to have enough money. Bankers and suppliers, naturally, are important in financing small business growth through loans and credit, but an equally important source of long term growth capital is the venture capital firm. Venture capital financing may have an extra bonus, for if a small firm has an adequate equity base, banks are more willing to extend credit.

This *Aid* discusses what venture capital firms look for when they analyze a company and its proposal for investment, the kinds of conditions venture firms may require in financing agreements, and the various types of venture capital investors. It stresses the importance of formal financial planning as the first step to getting venture capital financing.

What Venture Capital Firms Look For

One way of explaining the different ways in which banks and venture capital firms evaluate a small business seeking funds, put simply, is: Banks look at its immediate future, but are most heavily influenced by its past. Venture capitalists look to its longer run future.

To be sure, venture capital firms and individuals are interested in many of the same factors that influence bankers in their analysis of loan applications from smaller companies. All financial people want to know the results and ratios of past operations, the amount and intended use of the needed funds, and the earnings and financial condition of future projections. But venture capitalists look much more closely at the features of the product and the size of the market than do commercial banks.

Banks are creditors. They're interested in the product/market position of the company to the extent they look for assurance that this service or product can provide steady sales and generate sufficient cash flow to repay the loan. They look at projections to be certain that owner/managers have done their homework.

Venture capital firms are owners. They hold stock in the company, adding their invested capital to its equity base. Therefore, they examine existing or planned products or services and the potential markets for them with extreme care. They invest only in firms they believe can rapidly increase sales and generate substantial profits.

Why? Because venture capital firms invest for long-term capital, not for interest income. A common estimate is that they look for **three to five times their investment** in five or seven years.

Of course venture capitalists don't realize capital gains on all their investments. Certainly they don't make capital gains of 300% to 500% except on a very limited portion of their total investments. But their intent is to find venture projects with this appreciation potential to make up for investments that aren't successful.

Venture capital is a risky business, because it's difficult to judge the worth of early stage companies. So most venture capital firms set rigorous policies for venture proposal size, maturity of the seeking company, requirements and evaluation procedures to reduce risks, since their investments are unprotected in the event of failure.

Size of the Venture Proposal. Most venture capital firms are interested in investment projects requiring an investment of $250,000 to $1,500,000. Projects requiring under $250,000 are of limited interest because of the high cost of investigation and administration; however, some venture firms will consider smaller proposals, if the investment is intriguing enough.

The typical venture capital firm receives over 1,000 proposals a year. Probably 90% of these will be rejected quickly because they don't fit the established geographical, technical, or market area policies of the firm—or **because they have been poorly prepared.**

The remaining 10% are investigated with care. These investigations are expensive. Firms may hire consultants to evaluate the product, particularly when it's the result of innovation or is technologically complex. The market size and competitive position of the company are analyzed by contacts with present and potential customers, suppliers, and others. Production costs are reviewed. The financial condition of the company is confirmed by an auditor. The legal form and registration of the business are checked. Most importantly, the character and competence of the management are evaluated by the venture capital firm, normally via a thorough background check.

These preliminary investigations may cost a venture firm between $2,000 and $3,000 per company investigated. They result in perhaps 10 to 15 proposals of interest. Then, second investigations, more thorough and more expensive than the first, reduce the number of proposals under consideration to only three or four. Eventually the firm invests in one or two of these.

Maturity of the Firm Making the Proposal. Most venture capital firms' investment interest is limited to projects proposed by companies with some operating history, even though they may not yet have shown a profit. Companies that can expand into a new product line or a new market with additional funds are particularly interesting. The venture capital firm can provide funds to enable such companies to grow in a spurt rather than gradually as they would on retained earnings.

Companies that are just starting or that have serious financial difficulties may interest some venture capitalists, if the potential for significant gain over the long run can be identified and assessed. If the venture firm has already extended its portfolio to a large risk concentration, they may be reluctant to invest in these areas because of increased risk of loss.

However, although most venture capital firms will not consider a great many proposals from start-up companies, there are a small number of venture firms that will do only "start-up" financing. The small firm that has a well thought-out plan and can demonstrate that its management group has an outstanding record (even if it is with other companies) has a decided edge in acquiring this kind of seed capital.

Management of the Proposing Firm. Most venture capital firms concentrate primarily on the competence and character of the proposing firm's management. They feel that even mediocre products can be successfully manufactured, promoted, and distributed by an experienced, energetic management group.

They look for a group that is able to work together easily and productively, especially under conditions of stress from temporary reversals and competitive problems. They know that even excellent products can be ruined by poor management. Many venture capital firms really invest in management capability, not in product or market potential.

Obviously, analysis of managerial skill is difficult. A partner or senior executive of a venture capital firm normally spends at least a week at the offices of a company being considered, talking with and observing the management, to estimate their competence and character.

Venture capital firms usually require that the company under consideration have a complete management group. Each of the important functional areas — product design, marketing, production, finance, and control — must be under the direction of a trained, experienced member of the group. Responsibilities must be clearly assigned. And, in addition to a thorough understanding of the industry, each member of the management team must be firmly committed to the company and its future.

The "Something Special" in the Plan. Next in importance to the excellence of the proposing firm's management group, most venture capital firms seek a distinctive element in the strategy or product/market/process combination of the firm. This distinctive element may be a new feature of the product or process or a particular skill or technical competence of the management. But it **must** exist. It **must** provide a competitive advantage.

Elements of a Venture Proposal

Purpose and Objectives — a summary of the what and why of the project.
Proposed Financing — the amount of money you'll need from the beginning to the maturity of the project proposed, how the proceeds will be used, how you plan to structure the financing, and why the amount designated is required.
Marketing — a description of the market segment you've got or plan to get, the competition, the characteristics of the market, and your plans (with costs) for getting or holding the market segment you're aiming at.
History of the Firm — a summary of significant financial and organizational milestones, description of employees and employee relations, explanations of banking relationships, recounting of major services or products your firm has offered during its existence, and the like.
Description of the Product or Service — a full description of the product (process) or service offered by the firm and the costs associated with it in detail.
Financial Statements — both for the past few years and pro forma projections (balance sheets, income statements, and cash flows) for the next 3-5 years, showing the effect anticipated if the project is undertaken and if the financing is secured (This should include an analysis of key variables affecting financial performance, showing what could happen if the projected level of revenue is not attained.).
Capitalization — a list of shareholders, how much is invested to date, and in what form (equity/debt).
Biographical Sketches — the work histories and qualifications of key owners/employees.
Principal Suppliers and Customers
Problems Anticipated and Other Pertinent Information — a candid discussion of any contingent liabilities, pending litigation, tax or patent difficulties, and any

other contingencies that might affect the project you're proposing.

Advantages — a discussion of what's special about your product, service, marketing plans or channels that gives your project unique leverage.

Provisions of the Investment Proposal

What happens when, after the exhaustive investigation and analysis, the venture capital firm decides to invest in a company? Most venture firms prepare an equity financing proposal that details the amount of money to be provided, the percentage of common stock to be surrendered in exchange for these funds, the interim financing method to be used, and the protective covenants to be included.

This proposal will be discussed with the management of the company to be financed. The final financing agreement will be negotiated and generally represents a compromise between the management of the company and the partners or senior executives of the venture capital firm. The important elements of this compromise are: ownership, control, annual charges, and final objectives.

Ownership. Venture capital financing is not inexpensive for the owners of a small business. The partners of the venture firm buy a portion of the business's equity in exchange for their investment.

This percentage of equity varies, of course, and depends upon the amount of money provided, the success and worth of the business, and the anticipated investment return. It can range from perhaps 10% in the case of an established, profitable company to as much as 80% or 90% for beginning or financially troubled firms.

Most venture firms, at least initially, don't want a position of more than 30% to 40% because they want the owner to have the incentive to keep building the business. If additional financing is required to support business growth, the outsiders' stake may exceed 50%, but investors realize that small business owner-managers can lose their entrepreneurial zeal under those circumstances. In the final analysis, however, the venture firm, regardless of its percentage of ownership, really wants to leave control in the hands of the company's managers, because it is really investing in that management team in the first place.

Most venture firms determine the ratio of funds provided to equity requested by a comparison of the present financial worth of the contributions made by each of the parties to the agreement. The present value of the contribution by the owner of a starting or financially troubled company is obviously rated low. Often it is estimated as just the existing value of his or her idea and the competitive costs of the owner's time. The contribution by the owners of a thriving business is valued much higher. Generally, it is capitalized at a multiple of the current earnings and/or net worth.

Financial valuation is not an exact science. The final compromise on the owner's contribution's worth in the equity financing agreement is likely to be much lower than the owner thinks it should be and considerably higher than the partners of the capital firm think it might be. In the ideal situation, of course, the two parties to the agreement are able to do together what neither could do separately: 1) the company is able to grow fast enough with the additional funds to do more than overcome the owner's loss of equity, and 2) the investment grows at a sufficient rate to compensate the venture capitalists for assuming the risk.

An equity financing agreement with an outcome in five to seven years which pleases both parties is ideal. Since, of course, the parties can't see this outcome in the present, neither will be perfectly satisfied with the compromise reached.

It is important, though, for the business owner to look at the future. He or she should carefully consider the impact of the ratio of funds invested to the ownership given up, not only for the present, but for the years to come.

Control. Control is a much simpler issue to resolve. Unlike the division of equity over which the parties are bound to disagree, control is an issue in which they have a common (though perhaps unapparent) interest. While it's understandable that the management of a small company will have some anxiety in this area, the partners of a venture firm have little interest in assuming control of the business. They have neither the technical expertise nor the managerial personnel to run a number of small companies in diverse industries. They much prefer to leave operating control to the existing management.

The venture capital firm does, however, want to participate in any strategic decisions that might change the basic product/market character of the company and in any major investment decisions that might divert or deplete the financial resouces of the company. They will, therefore, generally ask that at least one partner be made a director of the company.

Venture capital firms also want to be able to assume control and attempt to rescue their investments, if severe financial, operating, or marketing problems develop. Thus, they will usually include protective covenants in their equity financing agreements to permit them to take control and appoint new officers if financial performance is very poor.

Annual Charges. The investment of the venture capital firm may be in the final form of direct stock ownership which does not impose fixed charges. More likely, it will be in an interim form—convertible subordinated debentures or preferred stock. Financings may also be straight loans with options or warrants that can be converted to a future equity position at a pre-established price.

The convertible debenture form of financing is like a loan. The debentures can be converted at an established ratio to the common stock of the company within a given period, so that the venture capital firm can prepare to realize their capital gains at their option in the future. These instruments are often subordinated to existing and planned debt to permit the company invested in to obtain additional bank financing.

Debentures also provide additional security and control for the venture firm and impose a fixed charge for interest (and sometimes for principal payment, too) upon the company.The owner-manager of a small company seeking equity financing should consider the burden of any fixed annual charges resulting from the financing agreement.

Final Objectives. Venture capital firms generally intend to realize capital gains on their investments by providing for a stock buy-back by the small firm, by arranging a public offering of stock of the company invested in, or by providing for a merger with a larger firm that has publicly traded stock. They usually hope to do this within five to seven years of their initial investment. (It should be noted that several additional stages of financing may be required over this period of time.)

Most equity financing agreements include provisions guaranteeing that the venture capital firm may participate in any stock sale or approve any merger, regardless of their percentage of stock ownership. Sometimes the agreement will require that the management work toward an eventual stock sale or merger. Clearly, the owner-manager of a small company seeking equity financing must consider the future impact upon his or her own stock holdings and personal ambition of the venture firm's aims, since taking in a venture capitalist as a partner may be virtually a commitment to sell out or go public.

Types of Venture Capital Firms

There is quite a variety of types of venture capital firms. They include:

Traditional partnerships—which are often established by wealthy families to aggressively manage a portion of their funds by investing in small companies;

Professionally managed pools—which are made up of institutional money and which operate like the traditional partnerships;

Investment banking firms—which usually trade in more established securities, but occasionally form investor syndicates for venture proposals;

Insurance companies—which often have required a portion of equity as a condition of their loans to smaller companies as protection against inflation;

Manufacturing companies—which have sometimes looked upon investing in smaller companies as a means of supplementing their R & D programs (Some "Fortune 500" corporations have venture capital operations to help keep them abreast of technological innovations); and

Small Business Investment Corporations (SBIC's)—which are licensed by the Small Business Adminsitration (SBA) and which may provide management assistance as well as venture capital. (When dealing with SBIC's, the small business owner-manager should intially determine if the SBIC is primarily interested in an equity position, as venture capital, or merely in long-term lending on a fully secured basis.)

In addition to these venture capital firms there are individual private investors and finders. Finders, which can be firms or individuals, often know the capital industry and may be able to help the small company seeking capital to locate it, though they are generally not sources of capital themselves. Care should be exercised so that a small business owner deals with reputable, professional finders whose fees are in line with industry practice. Further, it should be noted that venture capitalists generally prefer working directly with principals in making investments, though finders may provide useful introductions.

The Importance of Formal Financial Planning

In case there is any doubt about the implications of the previous sections, it should be noted: **It is extremely**

difficult for any small firm—especially the starting or struggling company—to get venture capital.

There is one thing, however, that owner-managers of small businesses can do to improve the chances of their venture proposals at least escaping the 90% which are almost immediately rejected. In a word—**plan.**

Having financial plans demonstrates to venture capital firms that you are a competent manager, that you may have that special managerial edge over other small business owners looking for equity money. You may gain a decided advantage through well-prepared plans and projections that include: cash budgets, pro forma statements, and capital investment analysis and capital source studies.

Cash budgets should be projected for one year and prepared monthly. They should combine expected sales revenues, cash receipts, material, labor and overhead expenses, and cash disbursements on a monthly basis. This permits anticipation of fluctuations in the level of cash and planning for **short term** borrowing and investment.

Pro forma statements should be prepared for planning up to 3 years ahead. They should include both income statements and balance sheets. Again, these should be prepared quarterly to combine expected sales revenues; production, marketing, and administrative expenses; profits; product, market, or process investments; and supplier, bank, or investment company borrowings. Pro forma statements permit you to anticipate the financial results of your operations and to plan **intermediate term** borrowings and investments.

Capital investment analyses and capital source studies should be prepared for planning up to 5 years ahead. The investment analyses should compare rates of return for product, market, or process investment, while the source alternatives should compare the cost and availability of debt and equity and the expected level of retained earnings, which together will support the selected investments. These analyses and source studies should be prepared quarterly so you may anticipate the financial consequences of changes in your company's strategy. They will allow you to plan **long term** borrowings, equity placements, and major investments.

There's a bonus in making such projections. They force you to consider the results of your actions. Your estimates must be explicit; you have to examine and evaluate your managerial records; disagreements have to be resolved—at least discussed and understood. Financial planning may be burdensome but it's one of the keys to business success.

Now, making these financial plans will not guarantee that you'll be able to get venture capital. Not making them, will virtually assure that you won't receive favorable consideration from venture capitalists.

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